APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT FILED MARCH 7, 2003

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 02-15498
D.C. No.
CV 01-2259 TEH

GREG SEINFELD,

Plaintiff-Appellant,

v.

CAROL BARTZ; JOHN T. CHAMBERS; MARY CIRILLO; JAMES F. GIBBONS; EDWARD KOZEL; JAMES C. MORGAN; JAOHN P. MORGRIDGE; DONALD VALENTINE; STEVEN M. WEST; CISCO SYSTEMS, INC.,

Defendants-Appellees.

Appeal from the United States District Court for the Northern District of California
Thelton E. Henderson, District Judge, Presiding

Argued and Submitted
December 5, 2002—San Francisco, California

Filed March 7, 2003

Appendix A

Before: Melvin Brunetti and A. Wallace Tashima, Circuit Judges, and David Alan Ezra, District Judge.*

Opinion by Judge Tashima

* * *

OPINION

TASHIMA, Circuit Judge:

Plaintiff-Appellant Greg Seinfeld appeals an order of the district court dismissing his action for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6). Seinfeld, a shareholder of Cisco Systems, Inc., filed a derivative action against Appellees, the company and its board of directors. In his complaint, Seinfeld alleged that Appellees violated § 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78n(a), and Rule 14a-9, 17 C.F.R. § 240.14a-9, by issuing a proxy statement that violated the proxy rules of the Securities and Exchange Commission ("SEC"). Specifically, Seinfeld contends that the proxy statement should have included the value of stock options granted to outside (non-employee) directors. The district court dismissed the complaint. We have jurisdiction pursuant to 28 U.S.C. § 1291, and we affirm.

---

* The Honorable David Alan Ezra, Chief United States District Judge for the District of Hawaii, sitting by designation.

Appendix A

BACKGROUND

Seinfeld has been a stockholder of Cisco since August 20, 1998. In 1999, the board of directors sought to amend Cisco's Automatic Option Grant Program for outside directors, which is part of the company's 1996 Stock Incentive Plan. As the district court summarized it:

> The amendment, which was approved by shareholder vote at the November 1999 annual meeting, raised the number of stock options granted to outside directors upon joining the board from 20,000 shares to 30,000 shares. Additionally, the amendment raised the number of options granted annually to each continuing outside director from 10,000 shares to 15,000 shares.

Appellees prepared a proxy statement dated September 27, 1999, in which they solicited the company's stockholders' proxies for approval of the amendment.

Seinfeld filed a complaint in the United States District Court for the Southern District of New York,[1] alleging that the proxy statement contained "materially false and misleading statements and omit[ted] material facts," in violation of SEC proxy rules. He contended that the proxy statement should have included the value of the option grants based on the Black-Scholes option pricing model, a model

1. The district court in New York granted Appellees' motion to transfer the case to the Northern District of California, where the events at issue took place, and where Cisco's headquarters and nearly all the witnesses, evidence, and defendants are located.

allegedly used by Cisco in its annual financial statements and used by the Financial Accounting Standards Board ("FASB"), the SEC, and the Internal Revenue Service ("IRS"). According to the complaint, the Black-Scholes model "measures the cost to the grantor to grant the stock option, . . . commonly referred to as the fair value or the Black-Scholes value of the option," relying on values such as "the volatility of the underlying stock, the risk-free rate of interest, the expiry of the option, the dividends on the underlying stock, the exercise price of the option, and the market price of the underlying stock." According to Seinfeld's calculations, the value of the annual stock option granted to each director on September 27, 1999, the date of the proxy statement, was $1,020,600, and the value on November 10, 1999, the date of the grant, was $630,900. The proxy statement stated that each director was paid an annual retainer of $32,000, plus stock options. Seinfeld alleged that this statement was materially false and misleading because, according to his calculations, the directors actually received annual compensation of $410,500.

Seinfeld also challenged a representation in the proxy statement that, " '[u]nless the market price of the Common Stock appreciates over the option term, no value will be realized from the option grants made to the executive officers.' " Seinfeld alleged that this statement was materially false and misleading because "the grant of stock options results in the immediate realization of value," which is best determined under the Black-Scholes model. Seinfeld further alleged that the proxy statement's representation of the tax consequences of the option grant was false because it failed to explain that stock options are taxable for federal estate

tax, gift tax, and generation-skipping transfer tax purposes and are valued using the Black-Scholes model.

The district court held that the Black-Scholes valuations of the option grants are not material facts that were required to have been contained in the proxy statement. The court further rejected Seinfeld's allegation that the proxy statement was misleading because it failed to disclose all federal tax consequences of the options. It therefore dismissed the complaint with prejudice in its entirety, pursuant to Rule 12(b)(6).

STANDARD OF REVIEW

The district court's dismissal under Rule 12(b)(6) for failure to state a claim is subject to de novo review. *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1035 (9th Cir. 2002). In reviewing a motion to dismiss, we must "take all well-pleaded allegations of material fact as true and construe them in the light most favorable to the plaintiff." *Desaigoudar v. Meyercord*, 223 F.3d 1020, 1021 (9th Cir. 2000), *cert. denied*, 532 U.S. 1021 (2001).

DISCUSSION

Section 14(a) of the Exchange Act makes it unlawful to solicit a proxy "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78n(a). Rule 14a-9 prohibits the solicitation of a proxy by means of a proxy statement that contains a statement that "is false or misleading with respect to any

material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. § 240.14a-9(a). "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). "In addition, a Section 14(a), Rule 14a-9 plaintiff must demonstrate that the misstatement or omission was made with the requisite level of culpability and that it was an essential link in the accomplishment of the proposed transaction." *Desaigoudar,* 223 F.3d at 1022 (footnote and citation omitted).

The essence of Seinfeld's complaint is that the proxy statement was misleading because it did not include the Black-Scholes valuation of the options granted to the non-employee directors. He makes several different arguments in advocating the use of Black-Scholes. We conclude that SEC regulations do not require the use of the Black-Scholes valuation and that the proxy statement is not materially false and misleading. In so holding, we agree with the Second Circuit, which faced the same issue in *Resnik v. Swartz,* 303 F.3d 147 (2d Cir. 2002).

Seinfeld's first argument is that the district court erred in relying on four lower court cases to reject the use of the Black-Scholes valuation model because this is inconsistent with our "holding" in *Custom Chrome, Inc. v. Comm'r,* 217 F.3d 1117 (9th Cir. 2000), that Black-Scholes is reliable. We reject this argument because, not only is *Custom Chrome* inapposite, but this was not even a holding in *Custom Chrome.*

Appendix A

The issue in *Custom Chrome* was the value, for federal income tax purposes, of warrants, which are, "in essence, options," that were issued in connection with a loan transaction. *Id.* at 1120. In that case, we were required to determine, under the Internal Revenue Code, when the warrants should be valued and what their value should be for original issue discount ("OID") purposes.[2] *Id.* at 1121-23. We stated in a footnote that Black-Scholes is one of several "well-established and reliable methods" of valuing options for OID purposes. *Id.* at 1124 n.10. The issue was the value of warrants for OID purposes in the federal income tax context. *Custom Chrome* in no way endorses the use of Black-Scholes to value options granted to outside directors, and it certainly does not require the use of Black-Scholes to value options for purposes of a proxy statement. Its reasoning simply is inapposite to the issue presented here.

Seinfeld's second approach is to rely on FASB Statement No. 123, *Accounting for Stock-Based Compensation,* to argue that Black-Scholes is a reliable pricing model. FASB Statement No. 123 deals with the reporting of employee stock options in a company's financial statements for purposes of "arriving at reported earnings." *FASB's Plans Regarding the Accounting for Employee Stock Options* (July 31, 2002), *available at http://www.fasb.org/news/nr073102.shtml.* "There are salient differences, however, between financial statement disclosure of an estimated value of stock options under a plan and disclosure for the purpose of shareholder

2. "When a loan is provided at a face value higher than the amount actually loaned, the debtor is allowed to deduct the difference over the life of the loan as [OID], while the creditor realizes the OID as ordinary income." *Custom Chrome,* 217 F.3d at 1121.

ratification of adoption of the plan." *Lewis v. Vogelstein,* 699 A.2d 327, 332 (Del. Ch. 1997); *see also Resnik,* 303 F.3d at 153 (stating that FASB Statement No. 123 recommends recognizing "options' grant-date value as part of compensation expense" in financial statements but "does not purport to address the requirements for reporting proposed compensation in a proxy statement"). FASB Statement No. 123 is not pertinent.

Seinfeld also contends that director compensation is a material fact required to be disclosed under § 14(a) and that the proxy statement fails to comply with SEC regulation disclosure standards. These contentions fail. First, the proxy statement did disclose director compensation.

Second, the proxy statement does comply with SEC regulation disclosure standards. Item 8 of Schedule 14A, 17 C.F.R. § 240.14a-101, dealing with the compensation of directors and executive officers, requires a proxy statement to furnish the information required by Item 402 of Regulation S-K, 17 C.F.R. § 229.402, if action is to be taken with regard to a compensation plan. Item 402(g) addresses the compensation of directors and requires the disclosure of compensation amounts, "including amounts payable for committee participation or special assignments," and "any other arrangements pursuant to which any director of the registrant was compensated." 17 C.F.R. § 229.402(g). As in *Resnik,* "[t]he description of the directors' standard fees and the options proposed to be awarded, as disclosed in the proxy statement . . . , plainly meets this basic requirement." 303 F.3d at 152. The proxy statement thus complies with SEC regulation disclosure standards.

Moreover, contrary to Seinfeld's contention, "neither subsection (g), nor any other provision of Item 402 expressly requires disclosure of the grant-date value of stock options proposed to be provided to the directors." *Id.* The court in *Resnik* compared subsection (g) with subsection (c) of Item 402, which requires the disclosure of the value of options granted to certain executive officers and specifically states that Black-Scholes is one possible way of calculating the value of the grant on the grant-date. *Id.; see* 17 C.F.R. § 229.402(c). "The absence of any mention of option values or of valuation methods from subsection (g), Compensation of Directors, is persuasive evidence that the Commission did not intend subsection (g) to require disclosure of grant-date value calculation for the options proposed to be awarded to non-employee directors." *Resnik,* 303 F.3d at 152.

Seinfeld contends that the regulations are only minimum disclosure standards and that compliance with the regulations does not necessarily guarantee compliance with Rule 14a-9. He relies on *Zell v. InterCapital Income Sec., Inc.,* 675 F.2d 1041 (9th Cir. 1982), in which we stated that " 'Schedule 14A sets minimum disclosure standards. Compliance with this schedule does not necessarily guarantee that a proxy statement satisfied Rule 14a-9.' " *Id.* at 1044 (quoting *Maldonado v. Flynn,* 597 F.2d 789, 796 n.9 (2d Cir. 1979)).

In support of his argument, Seinfeld repeats the allegations of his complaint that the following representation in the proxy statement was materially false and misleading: "Unless the market price of the Common Stock appreciates over the option term, no value will be realized from the option grants made to the executive officers." Seinfeld's only

argument that this is false and misleading, however, is that, according to FASB Statement No. 123, the options are best evaluated by the use of Black-Scholes. As discussed above, this FASB statement concerns financial statements, not proxy statements, and is not relevant to the issue presented here.

More importantly, the statement Seinfeld challenges is contained in a footnote to a table that lists option grants made in the last fiscal year to executive officers of the company, as required by Item 402(c), 17 C.F.R. § 229.402(c). Option grants that have already been made to executive officers are completely unrelated to the amendments to the plan Seinfeld is challenging, which concerned options proposed to be granted to outside directors. *Cf. Resnik,* 303 F.3d at 153-54 (rejecting a challenge to a similar statement, in part because, as here, the statement was contained in a footnote to a table describing options already granted to executives who were not covered by the plan at issue).

The facts of *Zell* are quite different from those presented here. In *Zell,* the plaintiffs charged the defendants, an investment fund, the investment manager, and the parent organization, with violations of § 14(a) and Rule 14a-9 by failing to disclose material information in two proxy statements. The proxy statements recommended approval of an agreement between the fund and a subsidiary of the parent, based in part on the parent's responsible management, financial strength, and investment skills. The proxy statements, however, failed to disclose that there were numerous lawsuits pending against the parent and the subsidiary charging violations of state and federal securities laws. We concluded that "it cannot be said that the omitted

information was so obviously unimportant that no reasonable Fund stockholders would consider it of actual significance in determining whether to approve" the agreement and therefore reversed the district court's grant of summary judgment in favor of the defendants. *Id.* at 1049. In finding the omitted information material, we reasoned that the proxy statements expressly relied on the corporations' financial stability and quality of management, that prior breaches of fiduciary duties or violations of securities laws "may have a direct bearing on managerial integrity," and that "[l]itigation involving substantial exposure to damages may affect a corporation's financial status." *Id.* at 1045-46.

The instant case does not present facts as compelling as those in *Zell.* In fact, the statement Seinfeld challenges as misleading is accurate; that is, the option grants made to the executive officers do not have value if the market price of the shares does not appreciate over the option term. *Cf. Resnik,* 303 F.3d at 154 (stating that a somewhat similar statement "accurately describes how value is realized when options are actually exercised").

Finally, Seinfeld contends that the proxy statement was misleading because it did not disclose federal estate, gift, and generation-skipping transfer tax consequences of the option grants. He argues that the IRS uses Black-Scholes to value stock options, citing in his complaint Rev. Rul. 98-21, 1998-1 C.B. 975, and Rev. Proc. 98-34, 1998-1 C.B. 983. The IRS publications to which Seinfeld refers deal with the valuation of stock options for federal transfer tax purposes; they have nothing to do with the valuation of options for purposes of disclosures in a proxy statement.

See Rev. Rul. 98-21 (describing the issue as the time that "the transfer of a nonstatutory stock option . . . by the optionee to a family member, for no consideration" becomes a "completed gift" under the Internal Revenue Code); Rev. Proc. 98-34 § 3 ("This revenue procedure applies only to the valuation for transfer tax purposes of nonpublicly traded compensatory stock options . . . ."). Seinfeld cites no law or SEC regulation that requires the disclosure in a proxy statement of federal transfer tax consequences of option grants to outside directors. Nor does he explain how the failure to discuss federal transfer tax consequences was a material omission. As the district court also reasoned, Appellees have not "falsely stated that the options have no consequences under these three tax schemes."

CONCLUSION

Even if we take all of the well-pleaded allegations of material fact as true and construe them in the light most favorable to Seinfeld, *see Desaigoudar,* 223 F.3d at 1021, he has not shown that the proxy statement made materially false or misleading statements or contained any material omission. The proxy statement complies with SEC regulations. "If appellant believes that Black-Scholes value disclosure should be mandatory whenever shareholders' approval is sought for a proposed option grant [to outside directors], his remedy is to advocate a change in the regulations before the [SEC]." *Resnik,* 303 F.3d at 155; *cf.* Rob Norton, *The Cure for Lavish Pay? Shame It to Death,* Wash. Post, Sept. 29, 2002, at B1, *available at* 2002 WL 101064666 (suggesting that the SEC could enact tougher standards for disclosure of corporate pay).

The judgment of the district court is **AFFIRMED**.[3]

---

3. Appellees argue that Seinfeld's complaint fails to meet the pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b). We do not address this argument because, even "assum[ing] for purposes of this appeal that [Seinfeld's] pleadings are sufficient under the Act's requirements . . . the underlying facts cannot establish liability under Rule 14a-9, a conclusion that would not be altered by more detailed pleading." *Minzer v. Keegan*, 218 F.3d 144, 148 n.1 (2d Cir. 2000), *cert. denied*, 531 U.S. 1192 (2001).

APPENDIX B — ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA DATED AND FILED FEBRUARY 8, 2002

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

NO. C01-2259 TEH

GREG SEINFELD,

Plaintiff,

v.

CAROL A. BARTZ, et al.,

Defendants.

ORDER

This matter came before the Court on January 28, 2002, on Defendants' Motion to Dismiss. Following oral argument, the Court issued its ruling from the bench GRANTING Defendants' motion with prejudice. This order describes the rationale for the Court's ruling in more detail.

FACTUAL BACKGROUND

Plaintiff is a shareholder of Defendant Cisco Systems, Inc. ("Cisco") and brings this suit as a derivative action against the company and its ten directors. At issue in this case is a 1999 amendment to Cisco's Automatic Option Grant Program for outside directors. The amendment, which was approved by shareholder vote at the November 1999 annual

meeting, raised the number of stock options granted to outside directors upon joining the board from 20,000 shares to 30,000 shares. Additionally, the amendment raised the number of options granted annually to each continuing outside director from 10,000 shares to 15,000 shares.

Plaintiff alleges that Defendants acted negligently in preparing their statement to solicit proxies to vote in favor of the amendment. The disputed proxy statement states that Cisco paid each outside director, except for Defendant Sarin, a $32,000 annual retainer fee for fiscal year 1999, and that it paid Defendant Sarin a $40,000 retainer fee to include board service commencing in September 1998. In addition, the statement represents that each director would receive periodic option grants under the Automatic Option Grant Program and was eligible to participate in the Discretionary Option Grant Program. The statement goes on to explain the number of options granted to each director, as well as the options' exercise prices and vesting requirements.

Plaintiff alleges that Defendants violated SEC proxy rules by failing to include the value of the option grants based on the theoretical Black-Scholes option pricing model. According to Plaintiff's Black-Scholes calculations, the value of the options granted to each of the continuing outside directors in 1998 was $369,500 on November 12, 1998 (the date of the grant) and $1,020,600 on September 27, 1999 (the date of the proxy statement). Plaintiff asserts that Cisco uses Black-Scholes to prepare its annual financial statements, and that it therefore would have been easy for Defendants to include the Black-Scholes valuations in the proxy statement. More significantly, Plaintiff alleges that Defendants'

statement of a $32,000 annual retainer fee plus stock options materially misrepresents the compensation of each outside director. Plaintiff contends that, using Black-Scholes, each director received compensation valued at well over $32,000.

In addition, Plaintiff alleges that the following sentence contained in the proxy statement is materially false and misleading: "Unless the market price of the Common Stock appreciates over the option term, no value will be realized from the option grants made to the executive officers." Plaintiff asserts that this statement is false because the grant of stock options results in the immediate realization of value, which is best determined using Black-Scholes. Moreover, Plaintiff contends that Defendants should have explained that stock options are valued using Black-Scholes for purposes of the federal estate tax, gift tax, and generation-skipping transfer tax, even if the options need not be so valued for purposes of the federal income tax.

LEGAL STANDARD

Dismissal is appropriate under Rule 12(b)(6) when a plaintiff's allegations fail to state a claim upon which relief can be granted.[1] Fed. R. Civ. P. 12(b)(6). In deciding whether a case should be dismissed, a court may generally only consider the complaint and any attached exhibits that have been incorporated therein. *See Lucas v. Dep't of Corrections,*

1. Defendants assert that the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995 apply to this case. The Court does not reach this issue because Plaintiff's claims fail to survive even the more lenient standards of Rule 12(b)(6).

66 F.3d 245, 248 (9th Cir. 1995) (considering material external to the complaint converts the motion into a Rule 56 summary judgment motion); *Parks Sch. of Bus., Inc. v. Symington,* 51 F.3d 1480, 1484 (9th Cir. 1995) (exhibits attached to the complaint and incorporated therein by reference are treated as part of the complaint for purposes of Rule 12(b)(6)). The court may also consider "documents whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the pleading." *Branch v. Tunnell,* 14 F.3d 449, 454 (9th Cir. 1994).

The court must accept as true the factual allegations of the complaint and construe those allegations in the light most favorable to the plaintiff. *Zimmerman v. City of Oakland,* 255 F.3d 734, 737 (9th Cir. 2000). It should not grant dismissal unless "it appears beyond a doubt that [the] plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Steckman v. Hart Brewing, Inc.,* 143 F.3d 1293, 1295 (9th Cir. 1998); *see also Conley v. Gibson,* 355 U.S. 41, 45-46 (1957). Moreover, dismissal should be with leave to amend unless it is clear that amendment could not possibly cure the complaint's deficiencies. *Steckman,* 143 F.3d at 1296.

DISCUSSION

Plaintiff alleges that Defendants negligently violated Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 of the Securities and Exchange Commission ("SEC"). Section 14(a) makes it unlawful to solicit proxies in violation of SEC rules. 15 U.S.C. § 78n(a) (2002). SEC

Appendix B

Rule 14a-9 prohibits solicitation of a proxy by a statement containing either (1) a false or misleading declaration of material fact or (2) an omission of material fact that makes any portion of the statement false or misleading. 17 C.F.R. § 240.14a-9 (2002).

An omitted fact is "material" if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). A plaintiff does not have to demonstrate that disclosure of the fact in question would have caused a reasonable shareholder to change his or her vote. *Id.* Instead, it is sufficient to establish a substantial likelihood that, "under all of the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." *Id.* In other words, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*

Failure to Include Black-Scholes Valuations in the Proxy Statement

Here, Plaintiff asserts that the Black-Scholes valuations of the option grants to the outside directors are omitted material facts. As Defendants point out, however, four courts that have considered Plaintiff's argument have rejected it at the pleading stage. *See Resnik v. Swartz*, No. 00 Civ. 5355 (LMM), 2001 WL 15671 (S.D.N.Y. Jan. 8, 2001); *In re 3Com Corp. Shareholders Litig.*, No. C.A. 16721, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999); *Cohen v. Calloway*, 667 N.Y.S.2d 249 (N.Y. App. Div. 1998); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997). The courts in all four of these

cases held that Black-Scholes valuations are not material as a matter of law. To the parties' and the Court's knowledge, no court has ever held to the contrary. The *In re 3Com* court even explicitly considered—and rejected—the plaintiff's argument that the "options have no value unless the market price of the stock rises" statement was misleading. *In re 3Com,* 1999 WL 1009210 at *6-8.

While not controlling precedent, the above cases are highly persuasive because of the factual similarities they share with the instant case. In three of the four cases,[2] the plaintiff alleged violation of disclosure laws based on proxy statements that identified outside director compensation in terms of dollar-amount retainer fees and number of stock options, without providing any theoretical calculations. *In re 3Com* involved a substantially identical claim to Plaintiff's—i.e., failure to disclose Black-Scholes valuations of option grants when seeking proxies to approve increasing the number of stock options granted to directors. *In re 3Com,* 1999 WL 1009210 at *1-2. *Lewis* also concerned a nearly identical claim, with the only difference being that the case involved solicitation of proxies to adopt, rather than amend, a stock option plan. *Lewis,* 699 A.2d at 329-30.

Plaintiff attempts to distinguish the three state-court cases—but, notably, does not even mention *Resnik* in his written opposition[3]—on grounds that they were applying

2. The *Cohen* order does not include a factual background, but the legal analysis indicates a similar, if not identical, fact pattern to the instant case.

3. At oral argument, Plaintiff observed that *Resnik* is currently on appeal to the Second Circuit, suggesting that this Court should (Cont'd)

state, rather than federal, law. Plaintiff correctly points out that the plaintiffs in the Delaware cases alleged breach of the state-law-based duty of candor, and not the federally defined Rule 14a-9.[4] However, the New York and Delaware courts applied the same "materiality" standard that this Court is bound to apply under the U.S. Supreme Court's decision in *TSC Industries*.[5] Thus, the fact that the state cases addressed state-law causes of action does not require this Court to reject the analysis in those cases.

Plaintiff next argues that a Ninth Circuit case, *Custom Chrome, Inc. v. Commissioner of Internal Revenue*, 217 F.3d 1117 (9th Cir. 2000), requires this Court to break new ground and reject the decisions made by the four courts discussed above. In *Custom Chrome*, the Ninth Circuit noted in a

---

(Cont'd)
therefore not consider the district court's ruling. However, the order of dismissal in *Resnik* still stands as good law; it has not yet been—and may never be—reversed. Moreover, even if the Court did not consider *Resnik*, Plaintiff would not gain any significant support. It would still be the case that the only courts to have considered claims similar to Plaintiff's have rejected such claims at the pleading stage.

4. The New York order does not specify plaintiff's claim, though this Court is willing to assume, as Plaintiffs argue and as Defendants do not dispute, that the claim was based on state law.

5. While the Delaware courts applied Delaware law to define "materiality," the Delaware standard is identical to that established in *TSC Industries*. *See In re 3Com*, 1999 WL 1009210 at *5. The New York court explicitly cited *TSC Industries* in its order. *Cohen*, 667 N.Y.S.2d at 249.

footnote that Black-Scholes was a reliable method of determining the value of the options at issue in that case. *Id.* at 1124 n.10. However, as Defendants correctly point out, the court explicitly distinguished the options at issue—which were issued as part of a loan transaction—from options granted for services rendered. *Id.* at 1122. In this case, Defendants received options for the services they rendered as Cisco's directors, and *Custom Chrome* is therefore distinguishable.

Custom Chrome is further distinguishable because tax regulations require that the options in that case be valued at the time of grant. *Id.* at 1122. Here, by contrast, nothing requires Defendants to calculate the value of the options at time of grant. Plaintiff argues that SEC regulations require Black-Scholes calculations, but he points to no specific regulation that requires them. Item 402(g) of Regulation S-K requires proxy statements to include information on the compensation of directors, but this regulation makes no mention of valuing options. 17 C.F.R. § 229.402 (2002). On the other hand, Item 402(c) requires statements to include "potential realizable value[s] of each grant of options" to executive officers, *id.;* but, notably, this provision does not apply to outside directors. Thus, the Court agrees with Defendants that no SEC regulation requires Black-Scholes.

Beyond that, even if Black-Scholes were reliable for purposes of tax regulations governing loans, it does not automatically follow that Black-Scholes calculations are material for purposes of determining whether a proxy

statement is false or misleading.[6] As a result, the Ninth Circuit's ruling in *Custom Chrome* does not diminish the persuasive weight of the four cases that have dismissed claims identical or similar to Plaintiff's.

Plaintiff's main argument to the contrary is that the Court should assume as true his allegation that Black-Scholes is applicable to the options at issue, and that the courts that have ruled on the matter improperly delved into factual issues on motions to dismiss. However, there is no reason to conclude that all four courts incorrectly applied the standard for ruling on a motion to dismiss.[7] Moreover, even if the Court were to accept that Black-Scholes were applicable to the options in this case, that does not mean that it must therefore assume as true Plaintiff's assertion that he has stated a valid claim for relief. Whether factual allegations are legally sufficient to state a claim cannot be assumed from the face of a complaint; indeed, that is exactly what a court must decide on a motion to dismiss.

---

6. Similarly, whether Black-Scholes calculations would pass all evidentiary standards required for admissibility under *Kumho Tire* is inapposite. *See Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999) (describing rules for admissibility of expert testimony). The Court notes with disapproval that Plaintiff presented this argument only at oral argument and not in his written opposition. However, even if Plaintiff's argument is correct—which this Court need not decide—the admissibility of Black-Scholes valuations does not make such calculations material for purposes of Rule 14a-9 analysis.

7. The state courts applied state procedural law, but the respective standards for dismissal are the same as for Rule 12(b)(6)—i.e., accept all factual allegations as true.

Based on the persuasive case law presented by Defendants, and the lack of convincing rebuttal by Plaintiff, this Court rules that, as a matter of law, Black-Scholes valuations are not material for purposes of Rule 14a-9 analysis. Consequently, Plaintiff has not stated a claim for relief, and the Court hereby GRANTS Defendants' motion to dismiss as to this claim. Because omissions must be material in order to be actionable, and Black-Scholes valuations are not material, it is clear that Plaintiff cannot allege any facts that would allow him to state a claim under this theory. Dismissal is therefore with prejudice.[8] *Cf. Resnik*, 2001 WL 15671 at *1 (S.D.N.Y. case dismissing similar claims with prejudice).

Failure to Disclose All Federal Tax Consequences

Plaintiff's second allegation is that the proxy statement is misleading because it fails to disclose all federal tax consequences when it describes the options' federal income tax consequences. However, as Defendants recognize and Plaintiff does not refute, no law or regulation requires Defendants to include the potential treatment of the option grants under the federal estate tax, gift tax, or generation-skipping transfer tax. Nor have Defendants falsely stated that the options have no consequences under these three tax

8. Plaintiff argues that his need to conduct further discovery should prevent dismissal of this case with prejudice. However, the Ninth Circuit has expressly stated that complaints in actions such as this one must be able to stand "on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed." *Medhekar v. United States District Court*, 99 F.3d 325, 328 (9th Cir. 1996) (per curiam).

schemes. As a result, Plaintiff's allegation can only give rise to a claim if omission of these tax consequences renders some other statement in the proxy statement false or misleading.

Plaintiff alleges that Defendants' omission renders misleading Defendants' representation that the option grants have no federal income tax consequences at the time of issue. The Court agrees with Defendants that this allegation is illogical. Stating that an act has no federal *income* tax consequences does not imply that the act has absolutely no federal tax consequences whatsoever. Plaintiff therefore fails to state a claim. *Cf. Stricklin v. Ferland,* No. Civ. A. 98-3279, 1998 WL 966023 at *7 (E.D.Pa. Nov. 10, 1998) (plaintiff who alleges that the proxy statement could have included additional information, without alleging anything to explain why the statement, as is, was materially misleading, fails to state a claim under Section 14(a)). Accordingly, the Court hereby GRANTS Defendants' motion as to this claim. Dismissal is with prejudice because it is clear that Plaintiff could not cure the deficiencies of his complaint even if given leave to amend.

CONCLUSION

For the above reasons, this Court GRANTS Defendants' Motion to Dismiss. Plaintiff's complaint is dismissed, with prejudice, in its entirety.

Appendix B

IT IS SO ORDERED.

DATED 2/8/02

s/ Thelton E. Henderson
Thelton E. Henderson, Judge
UNITED STATES DISTRICT COURT

APPENDIX C — STATUTORY AND REGULATORY PROVISIONS INVOLVED

15 U.S.C. § 78n

§ 78n. Proxies

(a) Solicitation of proxies in violation of rules and regulations

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title.

* * * *

Appendix C

17 C.F.R. § 240.14a-9

§ 240.14a-9 False or misleading statements.

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

* * * *

Appendix C

17 C.F.R. § 240.14a-101
SOLICITATION OF PROXIES

§ 240.14a-101 Schedule 14A. Information required in proxy statement.

* * *

Item 8. Compensation of directors and executive officers. Furnish the information required by Item 402 (§ 229.402 of this chapter) of Regulation S-K if action is to be taken with regard to:

(a) The election of directors;

(b) Any bonus, profit sharing or other compensation plan, contract or arrangement in which any director, nominee for election as a director, or executive officer of the registrant will participate;

* * *

(d) The granting or extension to any such person of any options, warrants or rights to purchase any securities, other than warrants or rights issued to security holders as such, on a pro rata basis.

* * *

Appendix C

Item 10. Compensation Plans. If action is to be taken with respect to any plan pursuant to which cash or noncash compensation may be paid or distributed, furnish the following information:

(a) Plans subject to security holder action.

(1) Describe briefly the material features of the plan being acted upon, identify each class of persons who will be eligible to participate therein, indicate the approximate number of persons in each such class, and state the basis of such participation.

(2)(i) In the tabular format specified below, disclose the benefits or amounts that will be received by or allocated to each of the following under the plan being acted upon, if such benefits or amounts are determinable:

Appendix C

New Plan Benefits		
Plan name		
Name and position	Dollar value ($)	Number of units
CEO.		
A.		
B.		
C.		
D.		
Executive Group.		
Non-Executive Director Group.		
Non-Executive Officer Employee Group.		

(ii) The table required by paragraph (a)(2)(i) of this Item shall provide information as to the following persons:

* * *

(C) All current directors who are not executive officers as a group; and

* * *

Appendix C

(iii) If the benefits or amounts specified in paragraph (a)(2)(i) of this item are not determinable, state the benefits or amounts which would have been received by or allocated to each of the following for the last completed fiscal year if the plan had been in effect, if such benefits or amounts may be determined, in the table specified in paragraph (a)(2)(i) of this Item:

* * *

(C) All current directors who are not executive officers as a group; and

* * *

Instructions

* * *

2. If action is to be taken with respect to a material amendment or modification of an existing plan, the item shall be answered with respect to the plan as proposed to be amended or modified and shall indicate any material differences from the existing plan.

* * * *

Appendix C

17 C.F.R. § 229.402
REGULATION S-K

§ 229.402 (Item 402) Executive Compensation.

* * *

Instruction to Item 402(b)

* * *

(c) Option/SAR Grants Table.

(1) The information specified in paragraph (c)(2) of this item, concerning individual grants of stock options (whether or not in tandem with SARs) and freestanding SARs (including options and SARs that subsequently have been transferred) made during the last completed fiscal year to each of the named executive officers shall be provided in the tabular format specified as follows:

[Table omitted]

(2) The Table shall include, with respect to each grant:

* * *

Appendix C

(vi) Either (A) the potential realizable value of each grant of options or freestanding SARs or (B) the present value of each grant, as follows:

* * *

(B) The present value of the grant at the date of grant, under any option pricing model (alternative column (f)).

Instructions to Item 402(c)

* * *

9. Where the registrant chooses to use the grant-date valuation alternative specified in paragraph (c)(2)(vi)(B) of this item, the valuation shall be footnoted to describe the valuation method used. Where the registrant has used a variation of the Black-Scholes or binomial option pricing model, the description shall identify the use of such pricing model and describe the assumptions used relating to the expected volatility, risk-free rate of return, dividend yield and time of exercise. Any adjustments for non-transferability or risk of forfeiture also shall be disclosed. In the event another valuation

method is used, the registrant is required to describe the methodology as well as any material assumptions.

* * *

(g) Compensation of Directors—

(1) Standard arrangements. Describe any standard arrangements, stating amounts, pursuant to which directors of the registrant are compensated for any services provided as a director, including any additional amounts payable for committee participation or special assignments.

(2) Other arrangements. Describe any other arrangements pursuant to which any director of the registrant was compensated during the registrant's last completed fiscal year for any service provided as a director, stating the amount paid and the name of the director.

Appendix C

Instruction to Item 402(g)(2)

The information required by paragraph (g)(2) of this item shall include any arrangement, including consulting contracts, entered into in consideration of the director's service on the board. The material terms of any such arrangement shall be included.

* * * *